

Introductory statement with Q&A

Jean-Claude Trichet, President of the ECB,
Lucas Papademos, Vice President of the ECB
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Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to today's press conference. Let me report on the outcome of our meeting, which was also attended by the President of the Eurogroup, Prime Minister Juncker, and Commissioner Almunia.

At today's meeting, we decided to raise the **key ECB interest rates** by 25 basis points. This decision was taken in view of the prevailing upside risks to price stability over the medium term that we have identified through both our economic and monetary analyses. Today's decision will contribute to ensuring that medium to longer-term inflation expectations in the euro area remain solidly anchored at levels consistent with price stability. Such anchoring is a prerequisite for monetary policy to make an ongoing contribution towards fostering sustainable economic growth and job creation in the euro area. After today's increase, given the positive economic environment in the euro area, our monetary policy is still on the accommodative side, with overall financing conditions favourable, money and credit growth vigorous, and liquidity in the euro area ample. Looking ahead, acting in a firm and timely manner to ensure price stability in the medium term is warranted. The Governing Council will monitor closely all developments to ensure that risks to price stability over the medium term do not materialise.

Allow me to explain our assessment in greater detail, starting with the **economic analysis**. Incoming information clearly confirms that the euro area economy continues to expand at a pace which is significantly stronger than generally expected a year ago. With a quarter-on-quarter rate of 0.6%, real GDP growth in the first quarter of 2007 was again somewhat above previous expectations. Other available information on economic activity, notably various surveys of business and consumer confidence, suggests that solid growth has continued into the second quarter.

Looking ahead, the medium-term outlook for economic activity remains favourable. The conditions are in place for the euro area economy to continue to grow at a sustained rate. As regards the external environment, global economic growth has become more balanced across regions and, while moderating somewhat, remains robust. External conditions thus continue to provide support for euro area exports. Domestic demand in the euro area is also expected to maintain its relatively strong momentum. Investment should remain dynamic, benefiting from financing conditions which remain favourable, accumulated and ongoing strong corporate earnings, balance sheet restructuring as well as business efficiency gains achieved over an extended period. Meanwhile, consumption should be supported by developments in real disposable income, as labour market conditions continue to improve.

This outlook is also reflected in the new Eurosystem staff macroeconomic projections. The projections foresee average annual real GDP growth in a range between 2.3% and 2.9% in 2007 and between 1.8% and 2.8% in 2008. In comparison with the previous ECB staff projections, the ranges projected for real GDP growth in 2007 are within the upper part of the ranges from March. For 2008, the ranges have been revised marginally downwards, following the increase in oil prices over recent months.

In the Governing Council's view, the risks surrounding this favourable outlook for economic growth are broadly balanced over the shorter term. At medium to longer horizons, the balance of risks remains on the downside, owing mainly to external factors. These relate in particular to fears of a rise in protectionist pressures, the possibility of further increases in oil prices, concerns about possible disorderly developments owing to global imbalances and potential shifts in financial market sentiment.

As regards price developments, oil prices have risen again over recent months. Accordingly, as reflected in Eurostat's flash estimate, annual HICP inflation was 1.9% in May 2007, unchanged from April but somewhat higher than expected a few months ago. Looking ahead, the short-term profile of annual inflation rates continues to be determined largely by current and past energy price developments, as last year's volatility in energy prices leads to significant base effects. On the basis of the current level of oil prices and oil price futures, which show an upward slope, annual inflation rates are likely to fall slightly in the months ahead before rising again significantly towards the end of the year.

Consistent with this view, Eurosystem staff projects average annual HICP inflation of between 1.8% and 2.2% in 2007 and between 1.4% and 2.6% in 2008. Compared with the March 2007 ECB staff projections, the range projected for inflation in 2007 is somewhat higher, largely reflecting higher oil prices. The projected range for inflation in 2008 is unchanged. In this context, let me remind you of the conditional nature of these projections, which are based on a series of technical assumptions, including assumptions for future short and long-term interest rates that are based on market expectations derived from the yield curve, as well as assumptions for oil and non-energy commodity prices.

At the policy-relevant medium-term horizon, risks to the outlook for price stability remain on the upside in the Governing Council's view. These risks relate notably to the domestic side. In particular, capacity utilisation in the euro area economy is increasing and labour markets are gradually improving. Accordingly, there is a risk that wage developments will be stronger than expected, which would pose significant upward risks to price stability. In addition, pricing power in market segments with low competition may increase in such an environment. It is therefore crucial that all parties concerned meet their responsibilities. Wage agreements in particular should be sufficiently differentiated to take into account price competitiveness positions, the still high level of unemployment in many economies and sector-specific productivity developments. The Governing Council stresses that wage developments should be avoided which would eventually lead to inflationary pressures and harm the purchasing power of all euro area citizens. In addition, upside risks to price stability arise from increases in administered prices beyond those anticipated thus far. Finally, on the external side, upside risks stem from the possibility of further unexpected oil price rises.

The **monetary analysis** confirms the prevailing upside risks to price stability at medium to longer horizons. The underlying rate of monetary expansion remains strong, in a context of already ample liquidity. The ongoing strength of monetary expansion is reflected in the continued rapid growth of M3, which reached an annual rate of 10.4% in April, as well as the still high level of credit growth. The strong rate of monetary and credit expansion reflects, in part, favourable financing conditions and solid economic growth.

In the short term, monetary and credit developments can be affected, inter alia, by the shape of the yield curve and external factors, and be subject to some degree of volatility. In assessing the policy-relevant underlying trends in monetary and credit growth, it is important to look through such transitory aspects. Taking this perspective, there are several indications that higher short-term interest rates are now influencing monetary dynamics, although they have not, as yet, significantly dampened the overall strength of the underlying rate of monetary and credit expansion. For example, increases in short-term rates have contributed to a more moderate expansion of the narrow aggregate, M1, in recent quarters. Equally, the annual growth rate of loans to the private sector has shown some signs of stabilising since mid-2006, albeit at double-digit levels. The stabilisation of loan growth is now becoming more broad-based, as evidenced in recent months by developments in borrowing by non-financial corporations and by households. At the same time, house price growth has come down somewhat, although remaining at high levels on average in the euro area.

Taking into account both short-term factors and the underlying trend of the continued vigorous expansion of money and credit, there are clear indications of upside risks to price stability at medium to longer-term horizons. Following several years of robust monetary growth, the liquidity situation in the euro area remains ample. In this environment, monetary developments continue to require very careful monitoring, particularly against the background of the expansion in economic activity and still strong property market developments.

To sum up, in assessing price trends it is important to look beyond any short-term volatility in inflation rates. The relevant horizon for monetary policy is the medium term. Risks to the medium-term outlook for price stability remain on the upside, relating in particular to the domestic side. As capacity utilisation increases and labour markets gradually improve, constraints are emerging which could lead in particular to stronger than expected wage developments. Given the vigorous monetary and credit growth in an environment of already ample liquidity, a **cross-check** of the outcome of the economic analysis with that of the monetary analysis supports the assessment that upside risks to price stability prevail over the medium to longer term. Accordingly, the Governing Council will monitor closely all developments in order to ensure that risks to price stability over the medium term do not materialise. This will support the solid anchoring of medium to longer-term inflation expectations in the euro area at levels consistent with price stability. Looking ahead, acting in a firm and timely manner to ensure price stability in the medium term is warranted.

As regards **fiscal policy**, all countries should be in line with the rules and provisions of the Stability and Growth Pact. This will be crucial for the smooth functioning of Monetary Union, given that the Stability and Growth Pact is an indispensable part of its institutional setting. Following the significant budgetary improvement recorded in 2006, the latest available forecasts suggest a further reduction in the government deficit-to-GDP ratio of the euro area over the period 2007-08. This reflects in particular projected ongoing strong revenue collection in the context of a favourable macroeconomic outlook. However, the structural improvement is more muted. The current economic "good times" should be used to rapidly redress the remaining budgetary imbalances in euro area countries as well as to accelerate the adjustment towards their medium-term objectives of sound budget positions with a focus on expenditure restraint. As agreed by the euro area finance ministers at the Eurogroup meeting in Berlin on 20 April, taking advantage of the favourable cyclical conditions would enable most euro area members to achieve their medium-term objectives in 2008 or 2009, and all of them should aim for 2010 at the latest. This is particularly important with a view to reducing the still high government debt ratios and preparing for the fiscal challenges arising from population ageing. In order to ensure that fiscal developments are monitored effectively, the Governing Council supports all efforts by Eurostat to improve the fiscal data situation. It also welcomes the increased emphasis placed by the ECOFIN Council on measures to improve the quality of public finances and increase the efficiency of public administration.

As regards **structural reforms**, the Governing Council fully supports any efforts that enhance competition, increase productivity and foster economic flexibility, thus promoting higher sustainable real GDP growth and employment. In this respect, we strongly back reforms focusing on reducing labour market rigidities, product market barriers and administrative burdens, and on stimulating technological innovation. Exploiting the complementary nature of reforms would increase their benefits in terms of long-term economic dynamism and price stability. Furthermore, the importance of a successful conclusion of the Doha round of trade talks for productivity and growth in Europe should not be underestimated. In the end, higher productivity growth will allow increases in real wages without negatively affecting employment, thereby supporting the income growth of the euro area workforce.

We are now at your disposal for questions.

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Transcript of the questions asked and the answers given by Jean-Claude Trichet, President of the ECB, and Lucas Papademos, Vice-President of the ECB

Question: *Mr Trichet, you have said that you see inflation at 2% for this year and next, and your forecasts are based on market expectations. These expectations comprise at least one more interest rate increase, so doesn't that mean that you need to raise rates more than that to get inflation below 2%? And the second question, capacity in the euro zone recently rapidly diminished: did this fact play a major role in your discussions today, and what relevance does it have for the future pace of monetary policy?*

Trichet: You heard what I said in my introductory statement. I said that we were still on the accommodative side. I said that the overall financing conditions were favourable. And we will observe all that is to come, as far as data, facts and figures are concerned, to do whatever is necessary to ensure price stability over time. There is no pre-commitment in what I have said. The Governing Council is alert

and we will do whatever is needed, as we have in the past, to ensure price stability and be credible in ensuring and delivering price stability.

Question: *Mr Trichet, the hike today marks a doubling in the main rate compared with 18 months before; we are now at 4%. Do you feel that this is a psychological point, and do you feel the need for strong vigilance in the future?*

Trichet: If there is a need for strong vigilance in the future, I will tell you when there is such a need. At the present moment, as I said, we will continue to monitor closely all developments to ensure that risks to price stability do not materialise over the medium term. Let me stress that inflationary expectations are anchored, according to various surveys and through different channels, in line with our definition of price stability: less than 2%, close to 2%. A number of surveys suggest that we are around 1.9%, which is in line with our definition. This solid anchoring of inflationary expectations is essential for the prosperity of Europe, is essential for sustainable growth and job creation in Europe. It is based entirely on the credibility of the ECB and our capacity to deliver price stability, not as judged by us, and not even as judged exclusively by Europeans, but as judged by the entire world. This is an ongoing contribution to sustainable growth and job creation. Let me remind all of us that since the euro was set up, we have created more than 12 million jobs. This is much higher than what was achieved in the eight years before the setting-up of the euro, which was over 2 million. And let me also say that it is even more than in the United States, what we have done over the last eight years as regards job creation. This has been permitted, in particular – of course not exclusively – by our capacity to anchor solidly expectations as regards price stability.

Question: *I would have two questions. The first one is, given the information that is available to you today, do you think that the euro zone economy could cope well with a slightly restrictive monetary policy stance? And the second question is: have you, has the Governing Council, discussed the financial turbulences in China and is there any concern that this may have an impact on confidence on this side here?*

Trichet: To your first question: again, we do what is necessary to counter inflationary risks and to be able to permanently deliver price stability over the medium term, which is the pertinent horizon. I will not say anything else than that. And you know that we don't have a mechanistic approach to our monetary policy. We look at everything, but we are not guided by a concept of neutral rate or a concept of output gap or a concept of NAIRU [non-accelerating inflation rate of unemployment]. We, again, are making our own judgement, based on collegial wisdom and on experience, on the basis of all information that is pertinent in order to counter the risks.

As regards China, we are observing global finances and global markets carefully. A number of events have been observed in the past and will probably continue to be observed in China. I have to say that what we have seen till now has been, it seems to me, quite well understood and absorbed by markets that have proved to be resilient, and I expect that it will continue to be so.

Question: *I noticed in your statement that you described policy as still being on the accommodative side, but you no longer describe the level of rates as "moderate" and said that the ECB would be monitoring developments "closely" rather than "very closely". So, would the message that this language is trying to give, assuming the economy grows strongly, be that rates still possibly have further to rise and that there might be a slightly longer gap between ECB rate moves than there has been in the past, and perhaps, to maybe make the question a little bit more specific, you talk obviously about risks and risks going forward and markets trying to price in risks as well, and I think at the moment there is about a two in three chance of markets pricing in ECB rates reaching 4.25% by September and I was just wondering if you would like to comment at all on that kind of risk pricing?*

Trichet: First of all, you are a very attentive observer. So you were right to note that we were on the accommodative side on the one hand, still, and you were also right to note that I did not say on behalf of the Governing Council that interest rates were moderate. I said that financing conditions were favourable. Also I have just repeated, in the previous response, that we are not pre-committed in any respect. Markets know that pretty well because it is our constant position. I will certainly not comment on the figure that you have been mentioning. There are various figures depending on certain methodologies. I will only say, yes, you have noted very carefully what I have said on behalf of the Governing Council. We are free to do what we would judge appropriate when the time comes, but at the present moment, I don't want to comment any more on probabilities.

Question: *A couple of questions. Is there any risk that there might be a press conference in August? The second question is: you talk this time about monetary policy still on the accommodative side. I just wonder if there is any German use of language behind that "still", perhaps meaning that at some point soon it will no longer be accommodative. And the third thing: I notice, when you talk about risk, you have inserted potential shifts in financial market sentiment as a potential risk this time. Can you explain why you have inserted that this time?*

Trichet: Again, we are not pre-committed in any respect and I will not comment on the "August" question. There is no particular case for me to say at this stage that we would meet physically in August. Again, we are never pre-committed. You know that and I will stress it once again.

On the "accommodative side" question, it is true that we said "still" and not "continues to be". You are a legendary, a very attentive listener, observer and watcher!

On the mention of potential shifts in financial market sentiment, it is something I have already said when responding to questions on the disorderly unwinding of global imbalances, namely that we were also incorporating in this concept the concept of a shift in market sentiment that would not be orderly and smooth but would be more sharp. I think there is nothing really new in the message of the Governing Council in this respect; it is an elaboration on that kind of possible risk that we see in the global economy.

Question: *I have two quick questions: What do you think is the earliest date that Romania can join the euro and what do you think are the biggest challenges the country is facing in preparation for that?*

Trichet: As with all countries that are a member of the European Union and not yet a member of the euro area, what is very important for us - because it is required by the Treaty - is that the convergence as measured objectively by the Treaty be met, and that means that a number of criteria be met, and be met on a sustainable basis. This is the wording of the Treaty. So it seems to me that Romania has a lot of homework to do. That homework is being done, and it has to continue to be done in an active fashion over a number of years in order to meet those criteria. It seems to me very clear that this means structural reforms, it means sound fiscal policy, it means sound monetary policy and also pursue liberalisation of all markets. And this is not only required by the convergence criteria, but is also very important in the national interest of any country, and in particular of Romania. That is as regards entry into the euro area. You had a second question?

Question: *Yes, what are the biggest challenges?*

Trichet: The biggest challenges, again, are probably the structural reforms and the overall sustainable delivery of a good macroeconomic policy – that is what really counts.

Question: *In the few years I've been covering the ECB the word "accommodative" has had quite a workout over time. You kept rates at historically low levels for quite some time. They are still on the accommodative side. I was just wondering whether you'd like to comment on whether you believe that rates at that level have served their purpose; whether since you are moving in several subtle ways to adjust how you describe rates, whether they have served the purpose that you have intended them to serve since you have been describing them as "accommodative". My second question to you is: because you have told us in other settings that, at times, the monetary pillar has influenced your decision-making at crucial times in the evolution of rates, would you describe this phase that we are now in and perhaps that we are looking at as a similar such phase?*

Trichet: I think that what we have been doing since our increase of rates in December 2005 has certainly served our purpose very well. We have anchored – in line with our previous record – the inflationary expectations in line with our definition of price stability over that year and a half. We have maintained fully our credibility and we have continued to serve our primary mandate. Because we have been faithful to our primary mandate – as it is a necessary condition for sustainable growth and job creation – we have served the European economy well. Let's remember that when we increased rates in December 2005 we had a number of observers, a number of institutions that were advising us not to do so. Today, at the present time, all of them, including the IMF and the OECD, are saying that we were very well-founded in that decision and in all the decisions we have been taking until now, including that one. So we have eight successive increases that are considered to be wise. We have been fully vindicated in what we have been doing.

As regards your second question, it's true that the monetary pillar played an important role when we took our decision in December 2005 and I said several times that it was one of the important reasons why we judged that it was time to act. And again, we have been vindicated. I would say the monetary pillar always plays its role in our two-pillar strategy. I have elaborated a little bit on behalf of the Governing Council on what is happening in terms of monetary developments. I mentioned the fact that some of the counterparts and some of the components of the monetary aggregates were signalling that our previous interest rate increases were influencing what we were observing: for instance, M1 in April was growing at 6.2%, in March it was 7%. And we will see what happens, but this clearly indicates that the change in our interest rates is operating in this respect. I would say for the loans to households, for instance, that it is interesting to see that April signals 7.6%, in March we had 7.9%, in Q4 2006 we were over 8%, in Q2 and Q3 2006 we were over 9%. So we see the influence of our interest rate increases in this respect, too. I could mention house purchases, the financing of house purchases, in the same way: in April 8.6%, in February 9.4%. So we see a number of elements that are interesting. I mention these and you know that our monetary pillar is based upon a broad and deep analysis of, components, of counterparts, of sectoral breakdowns and of a deep understanding of the dynamics that are behind it. This is considered by us as important, enlightening and as something which allows us to take the wisest possible decision on the basis of this binocular approach that we are very attached to.

Question: *I also have a couple of questions. First, we've had in the recent days a number of favourable upward revisions to expectations of US growth and also a diminishing of expectations of an interest rate decrease from the US Federal Reserve. I know you are not going to comment on any sort of interest rate policies outside your own but I do wonder whether this new optimism about the US growth prospects fits in with the ECB's perspective on the US economy. Secondly, I'd like to follow up on my colleague's questions about the monetary pillar. You've just elucidated the various components and in the statement I notice you say, and you repeated before, that there are clear indications of upside risks. That notwithstanding, there has been a number of reports recently that there is a division on the Council about how to interpret the money data. Could you comment on whether or not such a division exists? And a recurring question that I just feel needs to be asked again is whether or not you feel that the eurozone's potential growth rate has changed.*

Trichet: On the United States of America: I have always said that we very much rely upon the analysis of the Federal Reserve System and that we believe that their analysis is a pertinent one. I said that we have been vindicated ourselves in the recent past for our own analysis and judgement. And I would say that equally the Fed has been vindicated in its own judgement of the US economy. For us, we have always had good trust in the analysis of the Fed. It is something which I note with satisfaction.

On the second question, there is no division in the Governing Council on the monetary pillar. We are all attached, and the Governing Council as the pertinent entity is attached, to the monetary pillar. I have said already that the monetary pillar was in the monetary policy concept of a large number of national central banks, not only the Bundesbank but in my previous institution, Banque de France, in particular, we had an explicit reference to the monetary analysis. We have the same vision of the monetary analysis as being deep, broad, as aiming at having as profound an understanding as possible of the various dynamics that are inside the various components, the sectoral breakdown and the counterparts. We consider that in a universe which is more and more characterised by "financiarisation", or the role of finance in the modern economies, it is even more justified than before. Let me also say that we have the impression that in this respect quite a number of observers, academics and central banks are thinking that it is good to complement the economic analysis by a monetary analysis. I have already mentioned that my friend Mervyn King had said that publicly, including in a Select Committee of the House of Commons. And you could also see such sentiment expressed in a number of other central banks.

That was for your second question, and you had a third question on potential growth. On potential growth I would say that at this stage we are working a lot on this, but as far as the Governing Council is concerned, we would not underwrite a new assessment of the growth potential, even if some indications are there that labour productivity is picking up. To disentangle what is cyclical and what is structural in what we observe, we need time. We need appropriate research. If and when we conclude that it is time to modify our own estimate of the growth potential of the euro area, I will immediately tell you that. At this stage, on behalf of the Governing Council, I would say that I stick to what we had already said, with the sentiment that at around 2.25% we probably are in an area which might be pertinent. But, again, I don't exclude that we could modify our assessment – at this stage it would be premature.

Question: *Mr President, how great is the risk posed by hedge funds? I repeat this question once more looking towards the G8 summit in Heiligendamm where there is a point on the agenda. Until now there has been no solution on this point; we have a lack of transparency, a lack of regulations. How great is the risk of hedge funds and highly leveraged institutions for the markets?*

Trichet: It is an issue, you are absolutely right. It is an issue for the G8 summit of industrialised countries. I know the work which has been done by the German Presidency in this respect. I had a number of occasions myself to mention that the ECB was looking at this issue very carefully. As you may know, in the Financial Stability Report that we have published we mentioned explicitly that this was a very important issue.

Let me only say that we had already the report of the Financial Stability Forum at the level of the global economy which had been requested by the G8. The conclusions of this progress report are very interesting. I would say that we would very much subscribe to these conclusions and they are also in line with a number of national reflections. To sum up, it would rely very much on the core intermediaries being the key point to ensure an improvement of the situation. So the supervisory authorities would be called upon to ensure that the core intermediaries, particularly the big commercial and investment banks that are in direct contact with the hedge funds, have the best risk management practices possible, are correctly enlightened on all the risks they are taking and have a correct understanding and a correct information on what the hedge funds are doing. And that of course relies upon the vigilance of the supervisory authorities themselves, because these core intermediaries fall in their jurisdiction. There was a consensus on this report, and I am paraphrasing its conclusions: it is very important that these core intermediaries embark on the appropriate stress-testing in order to ensure that they would hold up in case of problems that would emerge from the sphere of the hedge funds. The core intermediaries are also called upon to reinforce considerably their call for transparency vis-à-vis hedge funds. And the hedge funds themselves are called upon to work out benchmarks on what would be the best behaviour possible as regards transparency vis-à-vis core intermediaries and transparency vis-à-vis their own investors – those individuals or entities that are giving them their capital – and a benchmark for their own internal risk management systems.

At this stage, I would say that it seems that there is a consensus that we should make progress along all the lines I have suggested, including the call to the industry itself to work out voluntarily what these benchmarks would be. I could perhaps call that a set of principles and I am very attached personally to the voluntary principles or benchmarks for appropriate behaviour and conduct that would be devised by the industry itself. I know that there is no consensus for administrative codes or new regulations. At this stage, I have to say that the ECB has never called for new administrative codes and regulations, but we are certainly calling for very active work in the various areas that I have mentioned, including the work to be done by the industry itself on a purely voluntary basis.

Question: *My question is very similar to the one of my Romanian colleague. What is the earliest date that you think Bulgaria can join the ERM? I remember your lecture in Sofia a year and a half ago, when you said that sportspeople should only participate in the Olympics when they are prepared enough, so what is the state of our preparedness now and what needs to be done?*

Trichet: It is an important question and I would give the same response as I already gave. It is good to enter when you are as fit as possible. I know that Bulgaria has done quite a lot of good work and we have to recognise that. The reforms are being pursued and real growth has been important, so Bulgaria is certainly to be congratulated for the results that have been obtained. On the other hand, it is clear that we still have imbalances in this country, including a very large current account deficit. So all this suggests a picture with strong points and weak points and we will see when the time comes what the position of the various authorities concerned, including of course the government and the central bank of Bulgaria, would be.

Question: *I have maybe similar questions. Slovakia revalued the central parity of the Slovak koruna three months ago but there is a sustainable appreciation of our currency. How do you look at this and could it be a problem for Slovakia to meet the criteria of exchange rate stability if the appreciation of our currency is too quick? Thank you.*

Trichet: We will see what happens. I think the previous decisions that were taken by the authorities of Slovakia were justified and I expect that the functioning of ERM II will continue to be as orderly as it has been in the past. We will see when the time comes what our judgement is on the stability of the currency. I

do not want to prejudge at this stage and we will see again if and when the Slovakian authorities are presenting a request.

Question: *I have two questions regarding the adoption of the euro in Cyprus. Firstly, I would like to ask you whether the European Central Bank has any action plans in the case of production of euro in the occupied area of northern Cyprus and secondly in the case of a solution and the reunification of the island. Thank you.*

Trichet: You know what our position on the Cyprus request is: we have already published, as well as the European Commission, our Convergence Report. I will not elaborate on that, it has been made public. We mentioned explicitly ourselves the reunification of Cyprus as being a challenge, an issue that we had to keep in mind. We did not conclude that it was premature or inappropriate for Cyprus to enter the euro area, but we meant that it was something which was very important for the future, if and when there is a reunification, in order for the negotiations from the economic and financial and monetary standpoint of the reunification to be very well crafted in the interest of Cyprus – which goes without saying – and also in the interest of the euro area as a whole. I have nothing to add to that.

Question: *You yourself and your colleagues from the US Federal Reserve, you have said repeatedly that global liquidity is extremely high and that markets are not correctly pricing risks. Do you think that the financial markets have been listening to what you are saying and reacting accordingly?*

Trichet: The notion of liquidity is a very complex notion. A number of market participants are mentioning liquidity to characterise the situation where they see “capital chasing investment” or “money chasing ideas”, something which they note as being a little bit exceptional, because in other times, and perhaps in more normal times, you see the contrary, you see “ideas chasing money or capital”, you see “investment chasing financing or capital”. This situation is clearly driven by a large number of reasons. And I do not want to elaborate too much on these reasons, but publicly, yesterday, on the occasion of the International Monetary Conference, together with Ben Bernanke and Toshihiko Fukui, we had elaborated on that and I had myself said: Look, you have perhaps five reasons why we are observing that *ex ante* savings are at a global level superior to *ex ante* investment. And that creates the present observation that the pricing of risks is lower than it would be in – I would say – more normal times. Among these various reasons you have certainly the fact that most emerging countries are posting big current account surpluses. You have the fact that in a number of economies, not in Europe now, but in a number of economies you had physical investment by corporate businesses that were lower than what would have been suggested by econometric equations based on past observations and it is certainly the case in the United States. And you had also among all those reasons the remarkable creativity that we are observing in the global financial markets as regards derivatives and the way of splitting, of repackaging, of reformatting risks with the consequence of enlarging formidably the scope of the investors that are risk buyers. And also a major reason would be the oil shock: the fact that we have additional forced savings that are adding up to the pot of savings that we have at a global level.

All this taken into account, I would say that we are – all of us, because we were in very good agreement – saying that we believe that we have to pave the way for some kind of orderly and smooth adjustment associated with the reassessment of risks. We say it not to dramatise the situation, but because there are very good reasons, namely what we are observing today on the market. On top of that, let us not forget that the real economy is performing well at a global level, but it seems to us that it is our duty to say: let us calmly prepare for a smooth and orderly reassessment of risks when the time comes, in order to avoid what would not be good for the real global economy, namely an adjustment which would not be orderly and smooth.

Question: *A very quick question, I should have asked earlier. Was there any discussion today about a possible 50 basis point increase, or did anyone suggest including in the statement any language that might suggest a further withdrawal of monetary accommodation would be warranted at some stage?*

Trichet: The answer to your first question is no and as regards your second question, I already made all the comments necessary.

Question: *Reading your introductory statement on the monetary analysis, I comprehend that the level of increase in M3 might be a threat to price stability, whereas the current increase in the speed is more or less due to special factors, including the rate hikes so far. So the level of the monetary growth is a threat,*

whereas the increase is not. Do you have a notion of a level at which this threat to price stability will diminish, or even disappear?

Trichet: I have said that what we consider pertinent is the overall analysis, which is not attached only to one particular aggregate, one particular component or one particular counterpart. We try to understand the dynamics of this complex matrix. And on the basis of our understanding of these dynamics we conclude that risks to price stability in the longer term are signalled by this overall analysis. We do not have a mechanistic approach, neither in the monetary nor in the economic analysis. So, in answer to your question, I would say that we make a judgement on the basis of all that we see. Our judgement today is that, for the longer term, there are risks to price stability embedded in what we are observing, even if the dynamics are very different as regards a number of counterparts.

***Question:** Just a quick question to make sure we are not working with the wrong assumptions here, but we've spent a lot of time parsing the opening statement as we usually do: are you intending to signal to us that there is per se a reason to move away from accommodative interest rates, because we generally are posing questions here in the direction that suggests that this is per se something that the Bank would like to do, that it's simply a question of when. Is it possible that this is maybe just a wrong assumption?*

Trichet: We have an understanding of the qualification of accommodation that is multi-dimensional. I said already that we do not refer to a neutral rate, and that we do not refer to any such concepts. We believe that, on the basis of all that we are observing, it is justified to say that we are still on the accommodative side. I do not want to elaborate more on that, other than to say that, in any case, the needle of our compass is that we make a judgement on what is necessary to counter inflationary risks at any given moment. We judge what is necessary to counter inflationary risks in various circumstances, and circumstances do not cease to change. Of course there are external influences, from the global economy, and there are a number of domestic factors that are moving, and they move in the ways that can be very significant. If I take, for instance, the last four quarters of the European economy – the last four quarters that are known – I was very impressed to see that now, as a very significant engine of growth, we have gross capital formation. I mentioned the fact that in the case of other economies, perhaps, this engine was not important. In our own case, if I take again the last four quarters, including the first quarter of this year, we have growth that would be around 3%, and half of the contribution comes from gross capital formation. That is very important and very impressive, and it shows the extent to which things might change quite rapidly in the present functioning and development of the European economy. That is important not only because the contribution to growth is important, but because it is a way of coping with what I mentioned as one of our emerging problems, namely the level of capacity utilisation. It is not by chance that we see this gross capital formation increasing in the productive sector; it is something which is important in order to cope with this pressure in the productive sector as regards capacity utilisation.

***Question:** Returning to some of your comments at the International Monetary Conference yesterday, I noticed that you said, regarding the Chinese yuan, that as far as talking about greater flexibility goes, moves in that direction should be more rapid, and I was wondering whether that was an intensification of your previous calls for greater flexibility in emerging Asian currencies. And then, moving on from that, looking at the euro's strength against the US dollar and the Japanese yen, whether you think that that strength is in line with the fundamentals of a strong European economy against less strong performance in the United States and Japan at the moment.*

Trichet: First of all, on the Chinese currency, I signalled yesterday, as I had before, that we were in full agreement with the United States, because we signed the very same communiqué of the G7. And I mention it as something which was absolutely obvious, that we had the same message and the same terms of reference agreed upon in a communiqué that we have had for a long time. Indeed, the first time was on the occasion of the G7 meeting at the beginning of 2004, when I signed it on behalf of the Governing Council of the ECB, together with the United States, Japan, the UK and Canada.

On the yen, I do not want to bore you, but I will repeat what I have already said that I have noted what the Minister of Finance and the Governor of the central bank have said, namely that markets should progressively take into account and recognise the progress that has been made in the domestic economy in Japan, progress which is very substantial. And on the United States of America, I would also say what I have already said: I had noted myself and it has been noted with great attention on this side of the Atlantic that the US authorities, including the Secretary of the Treasury, had said that a strong dollar was in the interests of the US economy.

Question: *Do you see any risk in adopting the euro in Cyprus, for fiscal conditions in the case of any conflict or crisis?*

Trichet: Again, we made our judgement, the Commission made its judgement, the decision has to be taken by the EU Council, namely by the college of governments and it will be made very soon. So I do not want to anticipate a decision which is a very important one and will be made at the appropriate level, namely at the level of Heads of States and Governments. Let me only say that for all countries that are members of the EU or members of the euro area, or already members of ERM II, the best handling of their own policies is absolutely of the essence. We have rules in Europe, one should respect the rules in Europe, and I have mentioned the particular attention that we would give if and when there is a reunification. It seems to us that it would be very important that the negotiation drives Cyprus and consequently the euro area in the best and soundest position possible.

Question: *What has been the impact of the series of interest rate changes on the Member States outside the euro zone, both those inside ERM II and outside ERM II? Has it helped or hindered and does the ECB really care?*

Trichet: The ECB has a mandate, the mandate is given by the Treaty, the mandate is to ensure price stability for 318 million people. By being credible in ensuring it in a vast continental economy which has a dimension of the order of magnitude of the United States of America, we are fulfilling a necessary condition for sustainable growth and job creation in Europe, in the euro area. Those who are members of ERM II are of course considerably helped by the fact that the anchor of their currency is reliable and credible.

Question: *Mr Trichet, I get the impression that the warnings from the central banks to financial markets are getting louder. But at the same time, for example, in Athens at that conference and in Cape Town I listened to your video transmission. I also get the impression that the banks are listening less and less. They are doing business in a booming economy, so how do you feel when you look at that? They do not really listen, many do not listen. I mean there are some comments in the IIF, in the press release of the IIF, but have you got a feeling that they listen to you?*

Trichet: I have a feeling that all the institutions concerned, commercial banks as well as investment banks, as well as highly-leveraged institutions are listening to what we say. I also have the sentiment that they are very much sharing our analysis. We are certainly not isolated in developing this analysis. They have improved their own resilience, it seems to me. They have improved their risk management concepts across the board. They have embarked on sophisticated stress-testing in order to complement the traditional value-at-risk computation, and so forth. So, I would have a relatively positive judgement on their awareness that they are living in an environment which includes risks and that it is their duty to take into account those risks and to be ready to weather a possible materialisation of those risks. I would not be negative at all in that respect. What remains true is that global finance has proved to be very resilient. The last two or three shocks that we had in recent years and months have been very rapidly absorbed by the market and we have to consider that it is also something which is important to see that when there are some shocks, they are absorbed by the normal functioning of markets. There are, as I said, good reasons for risks to be priced as they are. What we know is that the situation is not sustainable in the long run. What we are doing together, the central bank constituency on the one hand, the banking supervisory authorities on the other hand, as well as the industry, is to be done as seriously as possible to weather the adjustment when shocks materialise. As we say in the central banks, we are not paid not to worry, we are paid to worry! It is our duty to signal risks, and it is part of the signalling of risks that permits global finance and the global economy to be as impressive as they are. Do not forget that it is not a new phenomenon. We have an ongoing process since the crisis of the end of the 1990s, since the tech bubble explosion, since the Asian crisis, since LTCM [Long-Term Capital Management hedge fund], and so forth. We have been working a lot to improve, in particular, risk management and I take it again that it would be equally wrong to be too complacent and to underestimate the risks and also to say nothing is being done. A lot of things are being done but it is our duty to encourage all participants, including the private sector, to be as active as possible in doing a good job in this respect.

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